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¶1. (U) Summary. This is Volume 8, issue 25 of U.S. Embassy
Pretoria's South Africa Economic News Weekly Newsletter.

Topics of this week's newsletter are:
- Fitch Downgrades Outlook for SA to 'Stable'
- Rising Interest Rates and Inflation Add to
  Manufacturers' Woes
- SA Trade Policy 'Hurting the Poor'
- Retail Sales Drop Over Two Months
- Commodity Boom Drives SA Exports in 2007
- U.S. Displaces Japan as Largest Export Market,
  While China Closes in on Germany as the Largest
  Source of Imports
- Airport Expansion Costs Rise
- Solar-Powered Cars to Race in SA
- Volkswagen SA Wins Big Export Contract
- Infrastructure Bottlenecks Threaten Security of Fuel
  Transport
- NERSA Approves Limited Tariff Hike
- Anglo Slips to Fifth Place
- Mining Production Down
- ICT Costs Set to Drop Drastically
- Vodacom Explores Expansion in Africa
- IDC to Inject Funds Ahead of West Coast Cable
  Project Roll-Out
- Outsourcing Industry to Receive Boost from
  Improved ICT Infrastructure
End Summary.

Fitch Downgrades Outlook for SA to 'Stable'

¶2. (U) Global rating agency Fitch has downgraded the outlook on its credit rating for SA from positive to stable, citing rising inflation, political uncertainties, and a widening current account deficit. The downgrade means that while economic fundamentals are still seen as sound, the country is no longer in line for a possible upgrade to its BBB+ investment grade rating, which would have encouraged foreign investment. Foreigners have sold a net R9.2 billion ($1.2 billion) of local shares so far this year, fuelling concern about the funding of the current account deficit, which widened to about 9% of gross domestic product in the first quarter of this year. The widening shortfall will put more pressure on the weaker rand, which is stoking inflation, and might boost borrowing

by private and public sector corporations, forcing the country's external debt ratios to deteriorate. (Business Day, June 18, 2008)

Rising Interest Rates and Inflation Add to Manufacturers' Woes
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¶3. (U) The Bureau for Economic Research (BER) reported that the outlook for SA's manufacturing sector was "grim", with soaring inflation, rising interest rates, waning demand and business confidence sliding to a seven-and-a-half-year low in the second quarter of 2008. Furthermore, rising input costs, which reached a historic peak in the second quarter, are putting the profitability of producers under pressure as they are unable to pass on the full extent of input cost increases via higher selling prices. The BER survey showed manufacturing exports decreased despite the stimulus of a weaker rand. The rand has weakened by 16% against the dollar and 18% versus a trade-weighted basket of currencies this year, in a trend which would normally make local exports more competitive. However, the BER pointed out that manufacturing exports have now fallen for five years in a row, dashing hopes of a recovery spurred by the currency's steady decline. Furthermore, the manufacturing Qby the currency's steady decline. Furthermore, the manufacturing sector, which accounts for 14% of employment, reported job losses for the second quarter in a row, with that measure rising to a seven-year peak. Manufacturing output, which accounts for 16% of gross domestic product (GDP), fell by an annualized 1% in the first quarter of this year, helping to curb the economy's growth rate to 2.1%, its slowest pace for six-and-a-half years. (Business Day, June 18, 2008)

SA Trade Policy 'Hurting the Poor'

¶4. (U) Harvard Group panelist and University of Cape Town Economics Professor Lawrence Edwards strongly criticized SA's trade policy. Edwards said import tariffs were to blame for maintaining high consumer costs through high levels of protection for certain sectors, while promoting an anti-export bias and thus inhibiting growth. These findings are part of a study by the Harvard Group and were presented to government, business and labor representatives at the National Economic and Development and Labor Council (NEDLAC) on June 17. Edwards said it was "astounding" that high tariffs, such as a 40% tariff on beef, were maintained to protect local industries while SA was considering reducing the Value-Added Tax (VAT) on basic foodstuffs to protect the poor in the face of a global food crisis. Calling SA trade policy a "dartboard" approach, Edwards said that the average tariff on consumer goods was 20%. He said that while tariffs protected jobs in sectors such as clothing, textiles and cars, they constituted a tax on other sectors and consumers. Finance Minister Trevor Manuel has called for a more proactive approach towards trade liberalization to stimulate export-led growth and wants SA to adopt a unilateral trade liberalization approach. Meanwhile, Trade and Industry Minister Mandisi Mpahlwa supports an industrial policy approach, where industrial policy dictates trade policy and is geared towards protecting strategic sectors to drive manufacturing and growth. The Harvard study showed that protectionist trade policies had hampered export-led growth. It recommended the adoption of a single or dual-band tariff structure, abolishing tariffs on primary goods while capping tariffs on final goods at 15% or, in the case of a dual structure, maintaining tariffs on finished goods at 20% and 10%. (Business Day, June 18, 2008)

Retail Sales Drop Over Two Months

¶5. (U) Statistics SA (StatsSA) reported that retail sales decreased for the second month in a row by 0.3% y/y in April, after a fall of 1.5% y/y in March. Economists said the retail sector, which accounts for 14% of the economy, was set to remain under siege until

interest rates started to fall, which might not happen before 2010, given the bleak outlook for inflation. Many analysts expect another rise in lending rates at the SA Reserve Bank's next policy meeting in August. Interest rates have climbed by five percentage points in the past two years, taking prime lending rates up to 15.5%, a five-year peak. This has pushed debt costs as a ratio of disposable income for households up to more than 11% and curbed growth in spending to 3.3% in the first quarter of 2008, down from a peak of 9.5% in the last quarter of 2006. More stringent credit rules introduced a year ago have also eroded consumers' spending power and moderately curbed credit demand, while the latest electricity tariff increase will add to the burden on local consumers, already saddled with soaring prices for food and fuel. (Business Day, June 19, 2008)

Commodity Boom Drives SA Exports in 2007
QCommodity Boom Drives SA Exports in 2007

¶6. (U) SA's merchandise trade totaled $149.5 billion in 2007, an increase of 22.9% over 2006. Merchandise exports increased by 25% in 2007, driven by strong global demand, higher commodity prices, and a weaker rand. SA's 2007 export-basket was comprised of mining products (52%), manufactured products (45%), and agricultural products (3%). The top export product categories, accounting for more than 75% of SA's total exports, were precious minerals, iron and steel, machinery and mechanical appliances, mineral products, vehicles and transport equipment, and aluminum. Strong global demand for industrial commodities, metal, and mineral commodities, fueled by rapid economic growth in China and India, contributed to strong demand for SA's mining products. Precious minerals exports, including platinum, gold, diamonds and silver, increased by 21.7% to $18.9 billion, and constituted 27.1% of the total export basket in ¶2007. Merchandise imports increased by 21% in 2007, propelled by the SAG's multibillion-rand capital expansion program, fixed investment spending by the private sector, strong domestic consumer demand, and high oil prices. (South African Revenue 2007 Data)

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U.S. Displaces Japan as Largest Export Market,

While China Closes in on Germany as the Largest
Source of Imports
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¶7. (U) The U.S. was SA's largest export market in 2007, receiving 10.7% of exports and displacing Japan from the top spot. The value of SA exports to the U.S. increased by 27.5% y/y in 2007. Platinum-group metals, including platinum, palladium, rhodium and iridium, were the biggest export item to the U.S. in 2007, followed by vehicles and transport equipment. Much of the growth in vehicle and transport equipment exports can be linked to the preferential market access SA enjoys under AGOA. Germany was SA's biggest supplier of imports during 2007, followed by China, the U.S. and Japan. However, China is aggressively eating into Germany's position, and is currently SA's largest supplier of machinery and electrical equipment as well as textiles and apparel. China's share of SA's import basket increased from 9% in 2005 to 10.7% in 2007, while Germany's share decreased from 14% to 11.7% during the same period. Given current trends, China is expected to surpass Germany as SA's largest source of imports by 2010. (South African Revenue Service 2007 Data)

Airport Expansion Costs Rise

¶8. (U) Airports Company of South Africa (ACSA) CEO Monhla Hlahla announced that escalating construction costs would significantly impact ACSA's infrastructure upgrades. ACSA's estimated budget for infrastructure improvements between 2008 and 2012 was R19.3 billion ($2.4 billion) and has already risen by almost 14% to around R22 billion ($2.8 billion), owing largely to unprecedented inflation in

building materials costs. ACSA's planned infrastructure spending for 2008 was R3.8 billion ($475 million) for its nine airports, but the actual spending will be closer to R4.4 billion ($550 million) for the year. Airport-by-airport, the long-term capital injection was split into R11.4 billion ($1.4 billion) for OR Tambo International Airport, R2.5 billion ($310 million) for Cape Town International Airport, R6.7 billion ($840) million) for the Durban/La Mercy Airport, and the remaining R1.3 billion ($160 million) for the other national airports. The huge capital expenditure is to cater for the steadily increasing passenger numbers at the airports. Hlahla indicated that passenger numbers at the company's airports had increased yearly by 8.5% y/y and that domestic traffic had grown by 11%. This dramatic increase in capital costs has also been experienced by other public entities, such as state-owned power company Eskom. (Engineering News, June 19, 2008)

Solar-Powered Cars to Race in SA

¶9. (U) The Advanced Energy Foundation (AEF) is organizing an international solar-powered car race in SA in September 2008. Teams planning to participate in "The Solar Challenge" are already in the process of designing and building solar-powered vehicles. The vehicles are expected to have the capability to reach between 80km and 100km per hour without any external assistance. AEF head Winston Jordaan said the event would be an opportunity to showcase QWinston Jordaan said the event would be an opportunity to showcase cutting-edge solar technology innovations from around the world. Jordaan also noted that to win the contest, racers needed advanced technological prowess combined with exceptional strategy and tactics. Participants would set out on a 4,175km long distance race around the country, starting and finishing in Pretoria at the Innovation Hub. Two entrants will represent SA while other participants are expected to come from Australia, Holland, and the U.S. (Financial Mail, June 6, 2008)

Volkswagen SA Wins Big Export Contract

¶10. (U) Volkswagen SA (VWSA) has won a R12 billion ($1.5 billion) contract to supply its parent-company, the Volkswagen Group, with diesel particulate filters (DPFs) for the next five years. VWSA will complete the contract in partnership with local catalytic converter and exhaust systems manufacturer Eberspdcher SA, which

will share the production volume. A DPF is designed to remove diesel particulate matter or soot from the exhaust gas of a diesel engine, and is rapidly gaining popularity as global emission standards are becoming stricter. VWSA Managing Director David Powels said the deal was one of the biggest export contracts for a single part ever awarded to the SA company. "Furthermore, it is a coup for the SA automotive component manufacturing industry." Collectively, VWSA and Eberspdcher SA will invest about R55 million ($6.9 million) in tooling and equipment to manufacture the DPFs. In addition, investment in the broader national supplier base will reach about R26 million ($3.3 million). Eighty percent of these suppliers are based in the Nelson Mandela Bay region, in the Eastern Cape. VWSA estimated that the new contract will secure more than 100 new jobs in the region. It will use the most modern DPF manufacturing method, known as calibrated stuffing, which encompasses new laser measuring and sizing technologies. "This is the benchmark in the Volkswagen group and will benefit the SA catalytic converter industry as a whole," said Powels. "The decision to award the contract to VWSA proves emphatically that SA can be globally competitive in terms of pricing and technology, even when measured against the best global players in the DPF industry," said VWSA Purchasing Division Director Karlheinz Hell. Catalytic converters are SA's biggest single automotive component export and SA has a 14% market share in the global catalytic converter manufacturing industry. Export sales of catalytic converters reached R18.3 billion ($2.3 billion) last year, compared to R15.8 billion ($1.9 billion) in 2006. The SA catalytic converter industry

is based in SA because SA produces 80% of the world's platinum and because the SAG Motor Industry Development Plan (MIDP) program encourages value-added exports. (Engineering News, June 17, 2008)

Infrastructure Bottlenecks Threaten Security Of Fuel Transport
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¶11. (U) SA faces the possibility of fuel shortages when it hosts the 2010 FIFA World Cup. "In the third quarter of 2009 we are expecting that SA won't be able to supply our inland (fuel) needs unless something drastic is done," said Department of Minerals and Energy Deputy Director-General Nhlanhla Gumede. A re-engineering exercise to manage the transport of fuel from Durban to the industrial heartland in Gauteng is under way to ensure that there is no breakdown in supply over the next two critical years. The drive is geared towards improving the efficiency of rail transport of fuel ahead of the completion of Transnet's new R11.2 billion ($1.4 billion) multi-product pipeline between Durban and Gauteng. The pipeline is expected to be operational in the third quarter of 2010 and will reduce reliance on poor and inefficient road and rail transport infrastructure used to ferry fuel inland from the coast. According to Gumede, the Durban-Gauteng corridor is responsible for 68% of SA's total liquid fuels consumption. Growth in demand has created supply problems and if something is not done, inland Qcreated supply problems and if something is not done, inland shortages would be experienced. Gumede said about 25% of non-pipeline product was transported inland by rail, but road transport would have to be used unless rail transport was increased dramatically. This would mean more than 10 road tankers an hour would have to leave Durban in 2010, creating a continuous "train" of tankers on the highway. He said the only solution was to increase the efficiency of rail transport, slashing the Durban-Gauteng return journey from 10-14 days to not more than four days. He noted that "22.2% of GDP is linked to the availability of liquid fuel" and the economy would lose R1 billion ($125 million) per day without liquid fuels. Gumede noted that SA, Africa's largest economy, was a net importer of crude oil and was struggling to store enough fuel reserves to last beyond 10 days. A new Energy Bill before parliament proposes the creation of strategic fuel stocks, which would last at least 60 days. (Business Day and Engineering News, June 19, 2008)

NERSA Approves Limited Tariff Hike

¶12. (U) The National Energy Regulator of SA (NERSA) granted Eskom an additional 13.3% average increase in electricity tariffs in addition to the 14.2% already approved in December 2007. NERSA chairman Collin Matjila said NERSA decided to allow Eskom to recover additional primary energy costs of R2.8 billion ($353 million)

through its electricity tariff. The increase is well below the 53% (real) or 60% (nominal) increase that Eskom had asked for. Two weeks ago Business Report reported that NERSA hearings showed households would face a 76% increase in their municipal bills, and many industrial and commercial customers would be ruined, if the full 53% was granted. Municipalities had also expressed concern that the high prices would cause payment levels to drop and cases of illegal connections and tampering to escalate. However, NERSA's decision to not approve a higher rate could cause international credit rating agencies to downgrade Eskom's credit rating, increasing the future cost of Eskom's massive capital expenditure program. Another key factor in this decision will be whether the SAG decides to increase or bring forward its capital support for Eskom. (Engineering News and Business Day, June 18, 2008)

Anglo Slips to Fifth Place

¶13. (U) Anglo American has slipped from third to fifth spot in the ranks of global mining giants measured by market capitalization.

Anglo has given way to Brazil's Vale and China's Shenhua. Similarly, the "big four" mining countries Canada, U.S., Australia and SA have lost ground to the "BRIC four" of Brazil, Russia, India and China. Vale, formerly Companhia Vale do Rio Doce, has shot up the global ranks since the company's state-owned iron ore monopoly was privatized in 1997. Vale has averaged a 79% market capitalization growth rate over the past five years, much of it through acquisitions such as the purchase of Canada's Inco nickel miner. Anglo's slide can be attributed to its sell-off of non-mining and gold assets and its failure to bring major new production on stream, while rivals went on an acquisition spree. The annual Price Waterhouse Coopers survey of the global mining industry trends shows that the Top 40 companies grew their revenues by 32% in 2007, but their costs increased by 38%. The survey cites the growing pains of the industry as the three "ps", namely people, power and procurement. Skills and electricity shortages are the basic hindrances for SA, but procurement problems and rising costs are the result of global economic growth and demand for plant and equipment. (The Times, June 18, 2008)

Mining Production Down

¶14. (U) Statistics SA reported that mining production volumes for the three months to April 2008 fell by 4.1% when compared with the previous three months. The decrease was a result of a 5.5% drop in the production of gold and a 3.9% reduction in the output of non-gold minerals. The major contributors to the slump were platinum group metals, diamonds, and gold. However, coal production increased by 1.3%, softening the drop. On an annual basis, mining output for the first quarter decreased by 9% compared with the same period in 2007. Mining production for April fell by 2% compared with the same month a year ago. Gold production decreased by 10.1% in April compared with April 2007. Country-wide power cuts in January forced the mining sector to shut its large mines for five QJanuary forced the mining sector to shut its large mines for five days which curbed output. At present, mines are receiving only a 90-95% supply of power. Mining represents around 5.4% of the country's gross domestic product. (Business Report, June 19, 2008)

ICT Costs Set to Drop Drastically

¶15. (U) Financial Mail Analyst Duncan Mcleod said that mega-deals, triggered by state-controlled Telkom's review of its mobile strategy, are set to reshape the ICT sector and usher in a more competitive era in which SA communications costs will plummet. According to Mcleoad, doing business in SA will become cheaper and the economy, which for years has been hostage to Telkom's high prices, is set to reap the rewards. The Electronic Communications Act (ECA), introduced in 2006, gives licensed infrastructure operators a chance to build any type of network. Duncan said the legislation opened the way for a second fixed-line operator Neotel and mobile players MTN and Vodacom to compete directly with Telkom for the first time. Neotel recently unveiled its first retail consumer offerings, which significantly undercut Telkom's fixed-line

prices. Telkom is expected to respond on June 20, when it files its annual tariffs for approval by ICASA, the industry regulator. Analysts predict that if Neotel continues with is its policies, it may capture 10% to 15% of market share. Telkom, Neotel, Vodacom, and MTN are all also laying high-capacity, fiber-optic cables in metropolitan areas in the expectation of an explosion in demand for broadband. Three new undersea, fiber-optic cable projects, which will ultimately deliver 50 times the bandwidth capacity of the current Telkom-controlled Sat-3 system, will drive down international bandwidth costs between 70% and 90%. Analysts predict that monthly broadband prices will fall to below $20 for all-inclusive packages. (Financial Mail, June 13, 2008)

Vodacom Explores Expansion in Africa

¶16. (U) SA's Vodacom Group said it was exploring opportunities in Africa, but declined to say if it would take advantage of Mozambique's plan to license new fixed-line operators. Vodacom, SA's biggest mobile phone operator and jointly owned by the nation's largest fixed-line operator Telkom and Britain's Vodafone, launched its Mozambique mobile phone operation in December 2003. In the year to end-March, Vodacom Mozambique increased its customer base by 29.8% to 1.3 million, pushing its market share to about 40%. "Vodacom is always investigating opportunities to grow and expand its business," Vodacom Chief Operating Officer Pieter Uys told Reuters. "This process is ongoing and a variety of opportunities are being explored," he said when asked if Vodacom wanted to acquire a license to become Mozambique's second fixed-line operator. Vodacom has mobile phone operations in SA, Lesotho, the Democratic Republic of Congo, and Tanzania. Its growth beyond these countries has been hampered by a shareholder agreement between Vodafone and Telkom. Telkom is planning to sell its 50% stake in Vodacom to Vodafone and this will remove the agreement that prevents Vodacom from seeking expansion opportunities on the continent. The disposal of Vodacom stake would also enable Telkom to re-enter the mobile phone market. (Engineering News, June 18, 2008)

IDC to Inject Funds Ahead of West Coast
Cable Project Roll-Out

¶17. (U) The Industrial Development Corporation (IDC) has approved an equity investment of R500 million ($63 million) into the state-owned, ICT infrastructure company Broadband Infraco. Infraco is planning to build a $510-million "super cable" from Cape Town to London, which it hopes will be operational ahead of the 2010 FIFA World Cup. The African West Coast Cable (AWCC) project has been endorsed as a Presidential lead initiative for SAG. It involves the deployment of a 3,840 giga-bits-per-second, undersea, fiber-optic cable terminating in London, but incorporating branching units to at least ten countries along the West Coast of the African continent. The transaction is in its final stages and the IDC is reportedly ready to disburse the funds. Infraco is intent on facilitating the Qready to disburse the funds. Infraco is intent on facilitating the entry of as many as ten SA participants in the cable project, which will receive a capacity entitlement at a cost that is directly proportional to the size of the stake they buy. The open-access model would safeguard against monopolistic pricing. It would also mean that traffic to SA and London will terminate at "telecoms hotels" or "vendor-neutral zones", from where unrestricted onward connectivity rights will be guaranteed. According to press reports, the AWCC is advancing steadily towards financial negotiations with companies such as Telkom, Neotel, Equator Telecom Nigeria, British Telecom, Tenet, Tata Communications, Multichoice, Vox Telecom, Internet Solutions and Gateway Communications. Negotiations with equipment suppliers are also said to be at an advanced stage. Nevertheless, a decision will need to be made soon if the cable is to be completed in time for the 2010 FIFA World Cup. (Engineering News, June 20, 2008)

Outsourcing Industry to Receive Boost from
Improved ICT Infrastructure

¶18. (U) SA's outsourcing industry is set to benefit from increasing ICT competition and infrastructure investment. Last week, Neotel

announced that it would launch a "point of presence" (network entry point) in Johannesburg that would link with the global network of its parent-company Tata Communications. Neotel Product and Services Division Head Rajeev Sinha said the point of presence would benefit all companies with multiple offices across the world. "Instead of linking through London to seek another service provider, a client can now access the country directly via Tata's undersea fiber-optic cable network," he said. The Johannesburg point of presence will connect through Tata's global network to 600 cities and to customers

in 200 countries. Tata Communications Senior VP Genius Wong noted that SA was quickly becoming a favored location for business process outsourcing (BPO) and call centers. "By expanding our connectivity to SA, and our investment in the SEACOM (East Coast of Africa) cable, we're showing our commitment to support our customers as they expand into this burgeoning region", said Wong. He predicted that SA would become the third-largest BPO center in the world by the end of 2008. Frost and Sullivan Telecoms Analyst Lindsey McDonald said "astronomical" growth was possible for the SA BPO industry. Thus far, investment in training and the development of call centers in SA has been held back by high ICT costs. The South Africa Foundation said international leased-line prices in SA are three times as high as the next most expensive country and 31 times more expensive than the cheapest country. With the implementation of the SEACOM network in mid-2009, ICT costs are expected to fall by as much as 90%. Analysts predict that up to 10,000 jobs are expected to be created by the outsourcing industry within the next five years, though high labor costs could restrict growth. (Business Times, June 17, 2008)

TEITELBAUM